BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of the Milwaukee Water Works
for Authority to Increase Water Rates — Docket 3720-WR-108

REBUTTAL TESTIMONY OF PEIFFER BRANDT
ON BEHALF OF MILWAUKEE WATER WORKS

Q. Please state your name and business address.

A. My name is Peiffer Brandt. My business address is 1031 S. Caldwell Street, Suite 100, Charlotte, NC 28203.

Q. Have you previously submitted direct testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. The purpose of my rebuttal testimony is to respond to several issues identified by and arguments made by Mr. Philip Hanser (PSC REF#205708), Mr. Andrew Behm (PSC REF#205713), Mr. Patrick Planton (PSC REF#:205719) and Mr. Eric Rothstein (PSC REF#:205715) in their direct testimonies. In particular, my rebuttal testimony will focus on four topics: 1) the model used to develop the cost of service analysis and the rate design; 2) rate of return differential; 3) capital structure; and 4) public fire protection. In addition, I will make some general observations relevant to the rate case.

MODEL

Q. Is there a problem with the model?

A. No, the model is working correctly. We believe the reason Mr. Hanser has some concern with the model is there are manual steps that must be taken once changes are made in the

model to update it appropriately. The model is not fully automated. The model was constructed in this manner to require some user involvement to provide a check during updates. MWW views the model as a tool, not as an end on its own.

Q. Can you explain why Mr. Hanser believes the model is not calculating correctly?

A. We believe we know why Mr. Hanser is seeing the revenues increase when he changes the peaking factors. Lowering the industrial peaking factors allocates more costs to the wholesale customers and reduces the allocation of costs to the retail customers. The wholesale rates recalculate automatically within the model, increasing the wholesale revenue to match the increased allocated costs. The retail rates, however, do not automatically recalculate to a lower rate, but must be manually manipulated to determine rates that result in revenue neutrality.

Q. Do you believe that Mr. Hanser can manipulate the model without your assistance?

A. We are confident that Mr. Hanser can figure out the manual aspects of the model now that he will have more time to evaluate it. MWW does not believe it has the responsibility of providing a user manual for the model since it views the model as a tool for its use in preparing its rate case.

RATE OF RETURN DIFFERENTIAL

Q. Do you agree with Mr. Rothstein's analysis regarding the rate of return differential?

A. No. Mr. Rothstein takes the perspective that a differential is not warranted if the risks imposed by wholesale customers are not dissimilar or more pronounced than the risks associated with retail service. This perspective misses the point of the risk the owners of the system, the retail customers, face. The owners of the system bear risk that nonowners (wholesale customers) do not, whether these risks are imposed by the wholesale

customers or not. The discussion from the American Water Works Association (AWWA) Principles of Water Rates, Fees, and Charges, M1 Sixth Edition (M1 Manual) Chapter exemplifies this.

> "A government-owned utility may be considered to be the property of the citizens within the city. Customers within the city are owner customers who bear the risks and responsibilities of utility ownership. Inside-city customers cannot 'walk away' from the utility, and the utility has a responsibility to develop the system to serve all customers within the jurisdictional boundaries. In contrast, outside-city and wholesale customers are nonowner customers, and as such have no or different risks from the owners. As nonowners, these customers may have the ability and option to look to other entities to provide water service for them, or may also have the option to develop their own water systems."

Ms. Waymouth also mentions this section in her direct testimony, Direct-PSC-Anne Waymouth-9.

Q. Does MWW face financial risks that merit a differential rate of return?

Yes. There are a number of risks that MWW faces. As Mr. Rothstein notes that MWW does not hold sizeable cash balances, which is unusual for a utility the size of MWW. This lack of available cash places MWW at risk of being unable to pay vendors should revenue decline precipitously due to a general decline in consumption or the exit of a large volume customer. MWW is experiencing declining consumption, consistent with the trend in the industry. The test year consumption for this rate case is 7% lower for retail and 8% lower for wholesale when compared to the test year usage levels from the

2010 rate case. Ex.-MWW-Brandt-5 shows this decline. MWW also has the risk that a wholesale customer could go elsewhere for its water purchases. While the wholesale customers have contracts, these contracts only have 10 year terms, but the investments MWW must make to serve these customers have useful lives much longer than 10 years. If the contracts were permanent, the risk posed by the possibility of losing a wholesale customer would be minimized, but that is not the case. In fact, at least one wholesale customer, Shorewood, is currently evaluating alternative water providers (Ex.-MWW-Brandt-6). Nonetheless, MWW has an obligation to serve each customer. Finally, MWW has to cover any extraordinary operating costs. An example is the estimated $5 million in additional O&M expenses associated with the harsh winter this year.

Q. Mr. Behm describes the differential rate of return as a subsidy to the retail customers. Would you consider it a subsidy?

A. No, it is not a subsidy. The differential rate of return compensates the retail customers for the risk they take as owners of the system and for the cost of money associated with the retail customers fronting the cost of capital improvements. Please see Mr. Wright's rebuttal testimony for more detail on this topic.

Q. Mr. Rothstein mentions that MWW keeps limited reserves. Is that typical for a utility like MWW?

A. No. Most utilities have a financial policy or guideline regarding the level of reserves. To put the level of reserves in perspective, the Fitch Ratings cash reserves median for AA rated utilities is 266 days cash on hand. For MWW, that would equate to reserves of almost $36 million. MWW currently has no cash reserves and in fact is in a "due to" position to the City's general fund.

Q Does having limited reserves put MWW at more risk?

A. Yes it does because if there is an unexpected event that upsets the flow of revenues to MWW or that forces MWW to incur more costs (such as the estimated $5 million in additional O&M expenses associated with the harsh winter this year as mentioned above), MWW will increasingly rely on the City's general fund to meet obligations.

Q. Was the City of Oak Creek allowed a higher rate of return for wholesale customers in Docket 4310-WR-104?

A. Yes. The PSC granted the City of Oak Creek a differential of 180 basis points in the Amended Final Decision in the Oak Creek rate case (PSC REF#:185284).

Q. Is there a difference between the Oak Creek situation and the Milwaukee Water Works situation related to the wholesale rate of return?

A. No. The risk factors for Oak Creek regarding its wholesale customers are comparable to the risk factors for MWW. The one difference is that the percentage of revenue from its two wholesale customers is much higher for Oak Creek than the percentage of revenue MWW receives from its wholesale customers, which may be the justification for the PSC granting a differential of greater than 100 basis points.

Q. Did Mr. Rothstein represent the City of Oak Creek in its rate case filing?

A. Yes. Mr. Rothstein did represent Oak Creek but did not provide testimony related to the rate of return.

Q. The testimony of Mr. Planton mentions that the PSC denied the Kenosha Water Utility's proposed differential rate of return in Docket 2820-WR-106. Are there any other examples where the PSC has denied a requested rate of return differential?

A. Not to my knowledge. The PSC has reduced rate of return differentials, but has not denied the differential for other utilities.

Q. Why did the PSC eliminate the rate of return differential for Kenosha?

A. The PSC had not previously considered whether a differential rate of return was appropriate for Kenosha. The Commission found that, based on the wholesale water service agreement between Pleasant Prairie and Kenosha, Pleasant Prairie was a "captive customer" and that therefore Kenosha did not bear significant risk providing it with wholesale service. *Application of Kenosha Water Utility*, Final Decision, at 6 (PSC REF#:188160). The Commission relied on the agreement, which it found to require Pleasant Prairie to purchase its water exclusively from Kenosha in perpetuity. *Kenosha* does not break new ground on the Commission's analysis and is limited to the contractual relationship between the wholesale supplier and its wholesale customer.

Instead, a more complete discussion of the PSC's historical guidelines for differential rates of return is found in the Amended Final Decision in the Oak Creek rate case (PSC REF#:185284), pages 7-10. In *Oak Creek*, the PSC approved the requested 180 basis point differential. As explained in Direct-PSC-Waymouth-10, the Commission found "no compelling reason to place further limits on its historical guidelines" for approving differential rates of return other than to require Commission consideration of any water rate case in which a utility requests a differential rate of return greater than 100 basis points.

Q. Is the contact between Kenosha Water Utility and Pleasant Prairie Water Utility different than a typical MWW wholesale contract?

A. Yes. There are differences between the contract between the Kenosha Water Utility and Pleasant Prairie Water Utility and the MWW wholesale contracts. The KWU-PPWU contract is more restrictive, preventing Pleasant Prairie from purchasing water from any other providers and prohibiting the development of any alternative sources. The MWW contracts prohibit purchasing water from other providers but do not prohibit the development of alternative sources. Below is language from the Kenosha contract Ex.-PPWU-Pollocoff-3 (Ex.-MWW-Brandt-7) and a typical MWW contract (the example is from Wauwatosa). The full Wauwatosa contract is included as Ex.-MWW-Brandt-8.

KWU-PPWU Contract

> "Except as otherwise specifically provided in this paragraphs 1, the Village Parties shall purchase water exclusively from the KWU and shall not operate or use an alternative water supply source or alternative water treatment plant, and shall not contract or arrange with another person or entity for the operation or use of an alternative water supply source or alternative water treatment plant."

MWW-Wauwatosa Contract

> "Wauwatosa shall obtain all of its water from Milwaukee for distribution in the Service Area except for areas served by Wauwatosa from another water supplier as of the date of signing this agreement, and except as provide in Section II (j)."

In addition, the KWU-PPWU contract term is permanent (Ex.-.MWW-Brandt-7), while the Wauwatosa contract term is 10 years. This difference is very important because it shows that there is more risk associated with the MWW wholesale contracts.

Q. Are you aware of any rate cases where the PSC has discontinued a differential rate of return previously authorized for the wholesale supplier?

A. No.

Q. Are you aware whether Mr. Behm provided testimony in Milwaukee's last rate case, 3720-WR-107?

A. Yes.

Q. Do you know in what capacity Mr. Behm testified?

A. Yes. Mr. Behm provided several rounds of testimony in that case as a PSC staff witness. In particular, Mr. Behm prepared the cost of service study and subsequently submitted a revised cost of service study.

Q. Did Mr. Behm's cost of service study contain a differential rate of return between the retail and wholesale customers?

A. Yes. Both cost of service studies presented in that case by Mr. Behm contained 100 basis point differentials in the rates of return for MWW's retail and wholesale customers.

Q. Did Mr. Behm, while testifying as a staff member of the PSC working on the MWW's last rate case, raise any concern about the MWW having a 100 basis point differential between the retail and wholesale customers?

A. No, when it was Mr. Behm's job, as described by Anne Waymouth in her direct testimony Direct-PSC-Anne Waymouth-2 to "appear neither in support of nor in opposition to any cause, but solely to discover and present, if necessary, information pertinent to the docket", he did not raise a concern about the rate of return differential. However now that he has been engaged by a party challenging MWW's filing, he has raised this concern in his direct testimony.

Q. Did Mr. Behm raise other concerns while a staff member of the PSC working on MWW's last rate case?

A. Yes, Mr. Behm raised concerns about the allocation approach for transmission and distribution lines. He recommended using a cost-based approach as opposed to the inch feet approach that had been utilized previously. Mr. Behm's revised approach, which was in response to testimony from intervenors, was approved by the Commission. Mr. Behm also raised a concern about allocating public fire protection costs based on the populations of communities, attempting to lower Milwaukee's demand from 19,440,000 gallons to 12,960,000 gallons (Ex.-MWW-Wright-4). The Commission did not approve this modification, leaving the fire demand at 19,440,000 gallons.

CAPITAL STRUCTURE

Q. Please summarize Mr. Rothstein's recommendations with regard to adjustments to the allowed rate of return in order to account for MWW's capital structure.

A. Mr. Rothstein noted that MWW's capital structure is heavily weighted toward equity and suggests that the PSC abandon its practice with regard to determining an allowable rate of return on rate base and instead use an approach that is based on a misapplication of guidance provided by AWWA.

Q. How does the PSC determine what the appropriate return on rate base should be?

A. The PSC uses what has been termed a "capital structure neutral" approach to determine an appropriate rate of return that uses a proxy for the utility's actual cost of capital that is based on the cost of 30-year municipal debt plus an addition of 200 basis points in order to recognize that most utilities have used some equity, which typically has a higher cost than debt, to finance its assets. Unlike many regulatory commissions that use a utility's

weighted average cost of capital as the basis for setting an allowed rate of return, the PSC uses an approach that disregards the utility's actual capital structure and cost of each individual component capital, hence the term "capital structure neutral".

Q. How do other regulatory commissions determine an appropriate rate of return?

A. Each commission approaches this issue in slightly different ways, but many commissions set the allowable rate of return at the utility's weighted average cost of capital. This is the approach that is discussed in the section of the M1 Manual that Mr. Rothstein cites on pages 19 and 20 of his testimony. As described on page 47 of the M1 Manual a utility's cost of capital is determined by weighting the cost of each component of capital, debt and equity, by the proportion of the utility's total capital invested that each component represents. The example in the M1 Manual assumes a 50/50 capital structure and determines the weighted average cost of debt by multiplying the cost of debt (6%) by the portion of the total capital structure that is comprised of debt (50%) to yield a weighted cost of debt of 3%. (0.06 x 0.5= 0.03). The example then goes on to calculate the weighted average cost of equity in a similar manner and then adds the two values together to arrive at the weighted cost of capital, which in the case of this example is 8%. In this scenario capital structure is very important because the weighted average cost of capital for a utility that has a capital structure that is heavily loaded with generally higher cost equity will be higher than a very similar utility that has funded a larger portion of its investment in assets with lower cost of debt. In Wisconsin, the PSC has elected to use an approach that is capital structure neutral thereby removing capital structure from consideration when determining rate of return. The PSC's capital structure neutral

approach essentially treats all capital investment the same from a cost perspective regardless of whether that investment is funded with debt or equity.

Q. Why does Mr. Rothstein argue that the PSC should in this case deviate from its accepted practice of determining rate of return on a capital structure neutral basis?

A. Apparently Mr. Rothstein is under the impression the current approach will result in a $16.7 million dollar windfall to the City of Milwaukee, despite the fact that the only payment MWW makes to the City is the Net Property Tax Equivalent payment, which though calculated based on net assets, is not a return on assets. Additionally, if the PSC adopts his proposed approach to determining a fair rate of return, the allocation of costs to the wholesale customers will be less.

Q. How does Mr. Rothstein propose that MWW's rate of return be determined?

A. Mr. Rothstein first calculates an imputed return on equity based on the arbitrary assumption that MWW has a capital structure that is 50% debt and 50% equity. He then uses this imputed return on equity to back into an imputed rate of return of 3.11% and then claims that this approach would provide MWW with a return on equity that is consistent with the return on equity that is allowed for other major water utilities in Wisconsin.

Q. How does Mr. Rothstein justify his assumption that MWW's capital structure should be 50/50?

A. Mr. Rothstein supports his use of an arbitrary capital structure by citing language from the M1 Manual.

Q. Does the M1 Manual support Mr. Rothstein's Approach?

A. No it does not and his use of an example used in the M1 Manual is contrary to the M1 Manual's intended purpose. On page 20, lines 8 and 9, of his testimony Mr. Rothstein implies that AWWA recommends a capital structure of 50% debt and 50% equity since the example in the M1 Manual assumes this capital structure. As a contributing author to the M-1 Manual he should know that assumptions and examples used in the M1 Manual should not be construed as recommendations. As the Foreword to the Manual states:

> "As with the other manuals prepared by the Rates and Charges Committee and AWWA in general, this manual will not prescribe a solution. Rather, it is intended to provide guidance and advice. **The examples presented are used only to demonstrate the generally accepted methodologies discussed in this manual. The underlying data and assumptions are not endorsed or recommended either by AWWA or the Rates and Charges Committee for use elsewhere.** The purpose of this manual is to describe and present issues associated with developing water rates, fees, and charges, to enumerate the advantages and disadvantages of various alternatives, and to provide information to help users determine water rates, fees and charges that are most relevant to a particular situation. " (emphasis added)

Q. Does his approach provide MWW with a return on equity consistent with that allowed for other major Wisconsin water utilities?

A. No, it does not. As shown Ex.-MWW-Brandt-9, other Class AB water utilities in Wisconsin are allowed rates of return between 1% and 9% with the average allowed

return being 5.52%. Mr. Rothstein's approach yields a much lower rate of return that would limit MWW's ability to provide service in a sustainable manner.

Q. Does the M1 Manual support Mr. Rothstein's proposal to use a hypothetical capital structure?

A. No, it does not. The citation that Mr. Rothstein includes in his testimony pertains to whether or not a utility's actual capital structure or a hypothetical capital structure is used for the purposes of calculating the utility's weighted average cost of capital which would then be used as the allowed rate of return on rate base. This application of capital structure and whether one should use the actual capital structure or a hypothetical capital structure in the determination of the allowed rate of return is not relevant in this case since the PSC sets the allowed rate of return at the cost of 30 year debt plus two percent and does not calculate the allowed rate of return based on the utilities weighted average cost of capital.

Q. Is Mr. Rothstein's proposed capital structure more in keeping with the recommendation in the Public Service Commission's Water Utility Reference Manual than MWW's actual capital structure?

A. No. In fact, Mr. Rothstein's proposed 50/50 capital structure is not in compliance with the PSC Manual's recommendations in that the PSC Manual suggests that a favorable capital structure has "at least" 50 percent equity and "less" than 50 percent debt. Mr. Rothstein's proposed capital structure does not have less than 50 percent debt; however, MWW's actual capital structure does consist of less than 50 percent debt and has more than 50 equity.

Q. Mr. Rothstein notes that Milwaukee has a very low debt to equity ratio when compared to other utilities in Wisconsin. Does it make sense for Milwaukee to have a lower debt to equity ratio than other utilities in Wisconsin?

A. Yes. As the center of industry in Wisconsin over the last century, Milwaukee grew into a large city early. As such it has sizeable and old infrastructure. With the decline in industry and the decline in consumption due to enhanced efficiency of water appliances and fixtures, Milwaukee has the capacity and infrastructure to serve a larger population than it currently serves and has not needed to do growth related improvements in a long time. Growth related improvements are most commonly debt financed because these assets serve customers for many years so the cost should be paid over many years.

Q. Does the balance between debt and equity impact the revenue requirements or the allocation to the wholesale customers?

A. No it does not. The return component of revenue requirements is determined by applying a PSC endorsed rate of return to utility plant in service. The utility's capital structure has no role in the calculation. Mr. Rothstein's calculations are theoretical calculations that are dependent upon the PSC deviating from its long standing "capital recovery neutral" practice. Mr. Rothstein implies that a portion of these revenues are transferred to the City of Milwaukee; however, this is not the case. All of the revenues generated from the return on rate base are kept within MWW.

PUBLIC FIRE PROTECTION

Q. Does the population based demand have issues?

A. Yes. There is not a direct link between population and the true fire demand. Also, the method results in the retail demand being much higher than what seems intuitively to be

the case. Mr. Behm unsuccessfully argued for lower fire demands as PSC staff for the 2009-2011 Rate Case as mentioned previously.

Q. Is the population-based demand reasonable?

A. Given the trade-offs and the difficulty with developing fire demands that are reproducible and can be relatively easily updated, we believe the population-based demand approach for determining public fire demand is reasonable. We do believe this approach should be studied going forward to develop an approach that better meets the needs for MWW and its customers.

Q. What position did Mr. Behm take regarding the allocation of public fire protection charges to wholesale customers?

A. Mr. Behm recommends eliminating public fire protection charges to the wholesale customers.

Q. Earlier you mentioned that Mr. Behm did not raise concern in his testimony during the 2009-2011 Rate Case regarding the differential rate of return. Did Mr. Behm, while testifying as a staff member of the PSC working on the MWW's last rate case, raise any concern about allocating public fire protection costs to each of MWW's wholesale customers?

A. No. Mr. Behm's cost of service study allocated public fire protection costs to all of MWW's wholesale customers.

Q. Does Mr. Behm explain why the service situation between MWW and its wholesale customers is different now than it was at the time of the 2009-2011 Rate Case to justify eliminating public fire protection?

A. No, he does not.

GENERAL OBSERVATIONS

Q. On page 6 of Mr. Behm's testimony, Mr. Behm attempts to dismiss the idea that Milwaukee Water Works needs the requested rate increase on account of the fact that their revenues and operating expenses have increased and decreased, respectively, since 2010. Is that the case?

A. Mr. Behm compares the revenues that were forecast by the PSC under the newly approved rates in 2010 ($84,191,771) with the revenues that were forecast by the PSC under the existing rates in 2014 ($85,521,726). I believe that the purpose of this comparison was to argue that MWW does not need a steep rate increase because they are already projected to bring in $1.3 million more in revenues (1.6% increase) than was originally projected in 2010, in spite of decreased system demand.

However, the $84 million in revenue that he cites for projected 2010 revenue fails to take into account the impact of two simplified rate increases which occurred since 2010 – one in 2013 and one in 2014. Each of these simplified rate adjustments increased retail and wholesale rates by 3%, which has led to a compounded rate increase of just over 6% since 2010. However, projected revenues have only increased by 1.6% since 2010 because of the decrease in demand. The combined impact of the decrease in demand and the need to increase capital expenditures are two elements of the justification for MWW's rate increase.

Q. Did MWW make modifications only to shift costs from the retail to wholesale customers?

A. Absolutely not. MWW attempted to allocate costs as equitably as possible. Unfortunately there are some historic inequities that have benefitted the wholesale

customers and large retail customers that once corrected for result in greater impacts to these customers than the "average" impacts. If MWW had been intent on shifting costs to the wholesale and industrial customers, we would have established fixed charges on the greater of the existing charge and the calculated charge. As mentioned in my direct testimony, it is very common to do this and appears that MWW, through the decision of the PSC, has done this in the past.

Q. Has MWW attempted to develop a balanced cost of service and rate design in a transparent manner?

A. Yes it has. As any rate consultant would admit, there are different ways to look at a multitude of issues in preparing the cost of service and rate design. MWW attempted to select the most appropriate approaches given the constraints of previous MWW filing and PSC decisions. I am certain that the PSC is aware that the intervenors are attempting to reduce the costs for their constituents, while MWW is trying to balance the needs and objectives of all the customer classes and sought input from its customers during the process. Based on this input, MWW made certain adjustments. An example of MWW's efforts is meeting with the wholesale and suburban customers prior to the filing and making adjustments to the initial analysis based on input from the wholesale customers. In addition, MWW allocated the additional revenue associated with the 25% surcharge to suburban customer charges to the non-residential customers because those customers were seeing larger increases than the other retail customers.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.